

Auditing Procedures Report

Issued under P.A. 2 of 1968, as amended.

Local Government Type <input checked="" type="checkbox"/> City <input type="checkbox"/> Township <input type="checkbox"/> Village <input type="checkbox"/> Other		Local Government Name city of Detroit Sewer Fund	County wayne
Audit Date 6/30/04	Opinion Date 1/14/05	Date Accountant Report Submitted to State: 3/15/05	

We have audited the financial statements of this local unit of government and rendered an opinion on financial statements prepared in accordance with the Statements of the Governmental Accounting Standards Board (GASB) and the *Uniform Reporting Format for Financial Statements for Counties and Local Units of Government in Michigan* by the Michigan Department of Treasury.

We affirm that:

1. We have complied with the *Bulletin for the Audits of Local Units of Government in Michigan* as revised.
2. We are certified public accountants registered to practice in Michigan.

As part of obtaining reasonable assurance about whether the Local unit's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws and regulations, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not a objective of our audit, and accordingly, we do not express such an opinion. The results of our test disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*. "Yes" responses have been disclosed in the financial statements, including the notes, or the report of comments and recommendations.

You must check the applicable box for each item below.

- | | |
|---|---|
| <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No | 1. Certain component units/funds/agencies of the local unit are excluded from the financial statements. |
| <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No | 2. There are accumulated deficits in one or more of this unit's unreserved fund balances/retained earnings (P.A. 275 of 1980). |
| <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No | 3. There are instances of non-compliance with the Uniform Accounting and Budgeting Act (P.A. 2 of 1968, as amended). |
| <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No | 4. The local unit has violated the conditions of either an order issued under the Municipal Finance Act or its requirements, or an order issued under the Emergency Municipal Loan Act. |
| <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No | 5. The local unit holds deposits/investments which do not comply with statutory requirements. (P.A. 20 of 1943, as amended [MCL 129.91], or P.A. 55 of 1982, as amended [MCL 38.1132]). |
| <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No | 6. The local unit has been delinquent in distributing tax revenues that were collected for another taxing unit. |
| <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No | 7. The local unit has violated the Constitutional requirement (Article 9, Section 24) to fund current year earned pension benefits (normal costs) in the current year. If the plan is more than 100% funded and the overfunding credits are more than the normal cost requirement, no contributions are due (paid during the year). |
| <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No | 8. The local unit uses credit cards and has not adopted an applicable policy as required by P.A. 266 of 1995 (MCL 129.241). |
| <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No | 9. The local unit has not adopted an investment policy as required by P.A. 196 of 1997 (MCL 129.95). |

We have enclosed the following:

The letter of comments and recommendations.

Reports on individual federal financial assistance programs (program audits).

Single Audit Reports (ASLGU).

Enclosed	To Be Forwarded	Not Required
	✓	
		✓
	✓	

Certified Public Accountant (Firm Name)

KPMG LLP

Street Address

150 W. Jefferson Ave. Suite 1200

Accountant Signature

City

Detroit

State

MI

ZIP

48226

Date

3/15/05

CITY OF DETROIT SEWAGE DISPOSAL FUND

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KPMG LLP
Suite 1200
150 West Jefferson
Detroit, MI 48226-4429

Independent Auditors' Report

The Board of Water Commissioners,
the Honorable Mayor, and
Members of the City Council
City of Detroit, Michigan:

We have audited the accompanying balance sheets of the Sewage Disposal Fund (the Fund) of the City of Detroit, Michigan as of June 30, 2004 and 2003, and the related statements of revenues, expenses, and changes in fund net assets, and cash flows for the years then ended. These financial statements are the responsibility of the Fund's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in note 1, the financial statements of the Fund are intended to present the financial position, and the changes in financial position and cash flows, of only that portion of the business-type activities that is attributable to the transactions of the Fund. They do not purport to, and do not, present fairly the financial position of the City of Detroit, Michigan as of June 30, 2004 and 2003, and the changes in its financial position and its cash flows, where applicable, for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Sewage Disposal Fund of the City of Detroit, Michigan as of June 30, 2004 and 2003, and the changes in its net assets and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

The Fund has not presented Management's Discussion and Analysis, which accounting principles generally accepted in the United States of America have determined is necessary to supplement, although not required to be part of, the basic financial statements.

KPMG LLP

January 14, 2005

CITY OF DETROIT SEWAGE DISPOSAL FUND

Balance Sheets

June 30, 2004 and 2003

Assets	2004	2003
Current assets:		
Cash	\$ —	5,025,535
Investments	40,242,687	12,706,261
Due from other funds	40,413,894	60,686,397
Accounts receivable (including \$45,030,242 and \$45,151,145 for unbilled sewage services and net of allowance for doubtful accounts of \$42,901,655 and \$57,638,985 for June 30, 2004 and 2003, respectively)	112,592,864	107,755,552
Rate adjustments receivable from customers	35,273,060	28,804,864
Prepaid expenses	5,880	1,091,946
Prepaid interest	—	28,391,294
Inventories	10,890,503	14,256,072
Restricted cash	31,905,215	40,409,376
Restricted investments	349,717,460	765,214,976
Restricted due from other funds	20,688,810	2,380,429
Total current assets	<u>641,730,373</u>	<u>1,066,722,702</u>
Other assets:		
Restricted long-term investments	261,766,757	69,697,000
Unamortized bond issuance costs	31,105,792	31,140,008
Capital assets:		
Land	13,876,751	13,825,671
Structures	891,488,855	805,223,844
Interceptors, regulators, and improvements	532,455,750	536,209,238
Equipment	572,095,371	573,013,498
Construction work in progress	1,203,738,078	887,576,854
Total capital assets	3,213,654,805	2,815,849,105
Less accumulated depreciation	<u>(637,571,035)</u>	<u>(589,431,742)</u>
Net capital assets	2,576,083,770	2,226,417,363
 Total assets	 <u><u>\$ 3,510,686,692</u></u>	 <u><u>3,393,977,073</u></u>

See accompanying notes to financial statements.

Liabilities and Net Assets	2004	2003
Current liabilities:		
Current liabilities payable from current assets:		
Book cash overdraft	\$ 134,189	—
Accounts and contracts payable	13,928,353	12,675,475
Due to other funds	34,675,106	38,529,970
Accrued salaries and wages	1,455,830	1,198,300
Accrued compensated absences	6,051,544	5,573,893
Rate adjustments payable to customers	9,377,784	5,335,853
Accrued workers' compensation	1,181,346	1,160,901
Other current accrued liabilities	360,864	391,272
Total current liabilities payable from current assets	67,165,016	64,865,664
Current liabilities payable from restricted assets:		
Revenue bonds and revolving loan payable within one year	44,825,000	38,745,000
Accrued bond interest payable	25,691,034	28,957,186
Accounts and contracts payable	78,922,676	74,763,109
Due to other funds	5,207,146	6,783,755
Total current liabilities payable from restricted assets	154,645,856	149,249,050
Long-term liabilities:		
Revenue bonds and revolving loan payable, less current portion (net of unamortized discount and gains on defeasance of \$8,476,974 and \$13,497,164 for June 30, 2004 and 2003, respectively)	2,321,850,625	2,259,378,743
Deferred swap termination fees	14,056,137	—
Accrued workers' compensation	4,025,338	3,683,628
Accrued compensated absences	6,106,719	4,392,084
Total long-term liabilities	2,346,038,819	2,267,454,455
Total liabilities	2,567,849,691	2,481,569,169
Net assets:		
Invested in capital assets, net of related debt	610,829,187	592,045,473
Restricted for capital acquisitions and bond payments	130,303,233	92,574,778
Unrestricted	201,704,581	227,787,653
Total net assets	942,837,001	912,407,904
Total liabilities and net assets	\$ 3,510,686,692	3,393,977,073

CITY OF DETROIT SEWAGE DISPOSAL FUND

Statements of Revenues, Expenses, and Changes in Fund Net Assets

Years ended June 30, 2004 and 2003

	<u>2004</u>	<u>2003</u>
Operating revenues:		
General customers	\$ 140,989,543	132,259,087
Suburban customers	170,810,298	148,608,558
City departments	998,336	1,611,181
Sewage surcharge	3,155,337	1,918,934
Miscellaneous	3,856,227	3,713,383
Total operating revenues	<u>319,809,741</u>	<u>288,111,143</u>
Operating expenses before depreciation:		
Sewage treatment plant	108,834,440	102,795,411
Interceptors and regulators	182,574	52,145
Sewer pumping stations	5,076,606	2,816,201
Sewer maintenance and engineering	15,566,222	12,319,582
Combined sewage overflow control basins	1,141,192	1,606,591
Commercial	6,321,194	5,664,080
Administrative and general	45,861,755	42,492,794
Total operating expenses before depreciation	<u>182,983,983</u>	<u>167,746,804</u>
Operating income before depreciation	136,825,758	120,364,339
Depreciation	<u>50,085,670</u>	<u>44,013,270</u>
Total operating income	<u>86,740,088</u>	<u>76,351,069</u>
Nonoperating revenues (expenses):		
Earnings on investments	8,017,586	11,594,449
Interest expense, net of capitalized interest	(59,629,554)	(49,911,330)
Miscellaneous	(4,699,023)	1,247,175
Total nonoperating expense	<u>(56,310,991)</u>	<u>(37,069,706)</u>
Increase in net assets	<u>30,429,097</u>	<u>39,281,363</u>
Net assets – beginning of year	912,407,904	873,126,541
Net assets – end of year	<u>\$ 942,837,001</u>	<u>912,407,904</u>

See accompanying notes to financial statements.

CITY OF DETROIT SEWAGE DISPOSAL FUND

Statements of Cash Flows

Years ended June 30, 2004 and 2003

	<u>2004</u>	<u>2003</u>
Cash flows from operations:		
Receipts from customers	\$ 323,241,563	269,393,488
Transaction with other funds	(3,467,351)	(4,253,091)
Payments to suppliers	(109,592,661)	(103,299,761)
Payments to employees	(43,049,784)	(44,226,852)
Net cash provided by operating activities	<u>167,131,767</u>	<u>117,613,784</u>
Cash flows from capital and related financing activities:		
Acquisition and construction of capital assets, net	(354,410,519)	(325,223,422)
Principal paid on revenue bond maturities and revolving loan	(38,745,000)	(31,515,000)
Interest paid on revenue bonds	(113,346,957)	(100,625,459)
Principal paid on refunded debt	(103,845,000)	(204,145,000)
Proceeds from bond issuance and increase in revolving note payable, net	208,532,328	842,640,088
Swap termination fee	14,056,137	—
Unamortized discount and bond issuance cost	2,644,404	3,690,130
Other receipts	410,035	1,247,175
Net cash provided by (used in) capital and related financing activities	<u>(384,704,572)</u>	<u>186,068,512</u>
Cash flows from investing activities:		
Sales and maturities (purchases) of investments, net	195,891,333	(277,276,772)
Interest received on investments	8,017,587	11,594,449
Net cash provided by (used in) investing activities	<u>203,908,920</u>	<u>(265,682,323)</u>
Net increase (decrease) in cash	(13,663,885)	37,999,973
Cash at beginning of year	45,434,911	8,682,113
Cash at end of year	\$ <u>31,771,026</u>	<u>46,682,086</u>
Reconciliation of operating income to net cash provided by operating activities:		
Operating income	\$ 86,740,088	76,351,069
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation	50,085,670	44,013,270
Provision for uncollectible accounts	5,237,411	7,509,810
Changes in certain assets and liabilities:		
(Increase) decrease in accounts receivable	(10,074,723)	(18,187,007)
Decrease in rate refund receivable from customers	(6,468,196)	(1,777,823)
(Increase) decrease in prepaid expenses	29,477,360	(775,993)
Decrease in inventories	3,365,569	315,779
Increase in accounts and contracts payable	5,412,445	10,499,710
Increase in accrued salaries and wages	257,530	84,611
Increase in rate refund payable to customers	4,041,931	5,329,786
Increase (decrease) in other accrued liabilities and accrued compensated absences and accrued workers' compensation	2,524,033	(2,743,512)
Net change in due (to) from other funds	(3,467,351)	(4,253,091)
Net cash provided by operating activities	<u>\$ 167,131,767</u>	<u>116,366,609</u>

See accompanying notes to financial statements.

CITY OF DETROIT SEWAGE DISPOSAL FUND

Notes to Financial Statements

June 30, 2004 and 2003

(1) Summary of Significant Accounting Policies

The City of Detroit (the City) Charter established the Water and Sewerage Department (the Department) to supply water, drainage, and sewage service within and outside the City under the administration of the Board of Water Commissioners. The Sewage Disposal Fund (the Fund), an Enterprise fund, separately accounts for the Sewage Disposal System (the System), as is required by bond ordinances of the City. The following is a summary of the more significant accounting policies followed in the preparation of the Fund's financial statements. These policies conform to accounting principles generally accepted in the United States of America.

(a) *Basis of Accounting*

The financial statements have been prepared on the accrual basis of accounting. As allowed by Governmental Accounting Standards Board (GASB) Statement No. 20, the Fund follows all GASB pronouncements and Financial Accounting Standards Board Statements and Interpretations, Accounting Principles Board Opinions, and Accounting Research Bulletins issued on or before November 30, 1989, except for those that conflict with a GASB pronouncement.

(b) *Capital Assets*

Capital assets are recorded at historical cost, together with interest capitalized during construction. Depreciation is computed using the straight-line method over the estimated useful lives of the related assets as follows:

Improvements to land	67 years
Structures	40 years
Interceptors and regulators	100 years
Equipment	3 - 20 years

(c) *Inventories*

Inventories are stated at the lower of average cost or market.

CITY OF DETROIT SEWAGE DISPOSAL FUND

Notes to Financial Statements

June 30, 2004 and 2003

(d) *Workers' Compensation*

The Fund has no insurance coverage for workers' compensation claims. Workers' compensation expenses are recorded when the occurrence of the liability is probable and the amount is reasonably estimable. The amounts recorded as of June 30, 2004 and 2003 are based on compensation expected to be paid, along with estimated medical costs, for all claims known as of the balance sheet date, and historical data are used in computing the liability for estimated incurred but unknown claims as of the balance sheet date.

		June 30		
		2004	2003	2002
Balance at beginning of year	\$	4,844,529	6,970,321	6,819,314
Current year claims and changes in estimates		1,543,501	(964,891)	1,731,958
Claims payments		(1,181,346)	(1,160,901)	(1,580,951)
Balance at end of year	\$	<u>5,206,684</u>	<u>4,844,529</u>	<u>6,970,321</u>

All other significant areas of risk are covered by commercial insurance.

(e) *Capitalized Interest*

The Fund capitalizes qualifying net interest costs of the System on bonds issued for capital construction, in accordance with Statement of Financial Accounting Standards Nos. 34 and 62. Accordingly, capitalized interest for the years ended June 30, 2004 and 2003 was \$50,451,250 and \$24,991,172, respectively.

(f) *Taxes and City Services*

The Fund pays no direct federal, state, or local taxes, except local taxes on excess property and federal Social Security taxes. The Fund reimburses the City for most of the direct services furnished by other City departments, including general staff services. Charges are billed for all sewage services provided to City departments and the School District of the City of Detroit.

(g) *Shared Costs*

Costs related to shared facilities and personnel are allocated to the Fund on a basis which relates costs incurred to the fund benefited.

(h) *Compensated Absences*

The Fund records as a liability estimated vested vacation, sick pay, and banked overtime in accordance with GASB Statement No. 16, *Accounting for Compensated Absences*. Unused vacation pay accumulates until termination of employment, while there is no vesting of sick pay until an employee reaches age 60 or completes 25 years of service.

CITY OF DETROIT SEWAGE DISPOSAL FUND

Notes to Financial Statements

June 30, 2004 and 2003

(i) *Accrued Revenue*

The Fund records unbilled revenues for services provided prior to year-end by accruing actual revenues billed in the subsequent month.

(j) *Supplemental Disclosure of Cash Flow Information*

For purposes of reporting cash flows, the Fund considers "cash" as cash on deposit in financial institutions, including restricted cash.

(k) *Investments*

The Fund's investments are stated at fair value.

(2) **Definition of Operating Activities**

The Fund considers operating revenues and expenses to be those that result from activities related to the operations of the Sewage Disposal System.

(3) **Cash and Investments**

Investment decisions are made in accordance with the City's official investment policy, which is in accordance with Michigan Public Act 20 of 1943 as amended; Michigan Public Act 94 of 1933 as amended; and bond ordinance provisions.

(a) *Cash*

At June 30, 2004 and 2003, the book value of the Fund's deposits was \$31,771,026 and \$45,434,911, with a corresponding bank balance of \$32,112,638 and \$44,073,557, respectively. Qualifying deposits are insured by the Federal Deposit Insurance Corporation (FDIC) up to \$100,000. Of the bank balance at June 30, 2004 and 2003, \$200,000 per year is insured and the remaining \$31,912,638 and \$43,873,557 are uninsured and uncollateralized.

(b) *Investments*

The Fund's investments are categorized below to give an indication of the level of risk assumed by the Fund as of June 30, 2004 and 2003. Category 1 includes investments that are insured or registered or for which the securities are held by the Fund or its agent in the Fund's name. Pooled funds are not categorized as to investment risk.

	Category	June 30	
		2004	2003
Government investment pools	N/A	\$ 63,870,268	766,417,298
Mortgage-backed securities	1	376,083,241	19,593,996
Repurchase agreements	1	14,843,174	9,533,643
U.S. Government securities	1	196,930,221	52,073,300
		<u>\$ 651,726,904</u>	<u>847,618,237</u>

CITY OF DETROIT SEWAGE DISPOSAL FUND

Notes to Financial Statements

June 30, 2004 and 2003

In accordance with the Fund's investment policy, the Fund invests in mortgage-backed securities. These securities are reported at fair value in the balance sheet and are based on the cash flows from interest and principal payments by the underlying mortgages. As a result, they are sensitive to prepayments by mortgagees, which may result from a decline in interest rates. For example, if interest rates decline and homeowners refinance mortgages, thereby prepaying the mortgages underlying these securities, the cash flow from interest payments is reduced and the value of these securities declines. Likewise, if homeowners pay on mortgages longer than anticipated, the cash flows are greater and the return on the initial investment would be higher than anticipated. The Fund invests in mortgage-backed securities to diversify the portfolio and to increase the return while minimizing the extent of risk.

(4) Restricted Assets

Restricted assets, principally cash and investments, are available for debt service on revenue bonds and to provide funds for improvements, enlargements, extensions, and construction. In certain instances, minimum levels of assets are required by bond ordinance provisions or by Board of Water Commissioners decree. These assets are maintained as follows: (1) With respect to the Bond and Interest Redemption Fund, after provision has been made for expenses of operation and maintenance of the System, a sum proportionately sufficient to provide for payment, when due, of the current principal and interest is set aside. The Bond Reserve account is part of the Bond and Interest Redemption Fund, and the amounts credited to this account are to be used only to pay principal and interest on the bonds when current revenues are not sufficient. (2) With respect to the Extraordinary Repair and Replacement Reserve Fund, after meeting the requirements of the foregoing funds, monthly deposits in an amount equal to one-twelfth of 3% of the budgeted operation and maintenance expense of the System for the fiscal year must be set aside until the aggregate amount funded totals at least 15% of that year's budgeted operating and maintenance costs. These deposits are to be used for major unanticipated repairs and replacement to the System with actual or anticipated cost exceeding \$1 million. Once this fund is fully funded, deposits required are amounts needed to maintain fully funded status. Borrowings of up to 50% of the balance in this fund on the first day of the related fiscal year are allowed for transfer to and use from the Improvement and Extension Fund. Any such borrowings must be repaid prior to any deposits being made to the Improvement and Extension Fund. (3) After the above deposits have been made, excess amounts may be deposited in the Improvement and Extension Fund, established for the payment of improvements, enlargements, repairs, extensions, or betterment to the System. (4) With respect to the Construction Fund, the portion of the proceeds of the sale of bonds for building or improving the System is deposited in this fund. A separate depository account is required for each series of bonds. Proceeds for construction purposes received from federal and state grants and other sources which restrict the use of such proceeds are also deposited into this account.

CITY OF DETROIT SEWAGE DISPOSAL FUND

Notes to Financial Statements

June 30, 2004 and 2003

(5) Capital Assets

Capital asset activity for the fiscal years ended June 30, 2004 and 2003 is as follows:

	Balance, June 30, 2003	Additions	Disposals	Balance, June 30, 2004
Nondepreciable assets:				
Land	\$ 13,825,671	51,080	—	13,876,751
Construction in progress	887,576,854	399,832,718	(83,671,494)	1,203,738,078
	<u>901,402,525</u>	<u>399,883,798</u>	<u>(83,671,494)</u>	<u>1,217,614,829</u>
Depreciable assets:				
Interceptors, regulators, and land improvements	536,209,238	207,094,417	(210,847,905)	532,455,750
Structures	805,223,844	291,326,004	(205,060,993)	891,488,855
Equipment	573,013,498	174,279,862	(175,197,989)	572,095,371
Accumulated depreciation	(589,431,742)	(50,085,670)	1,946,377	(637,571,035)
	<u>1,325,014,838</u>	<u>622,614,613</u>	<u>(589,160,510)</u>	<u>1,358,468,941</u>
Total	\$ <u>2,226,417,363</u>	<u>1,022,498,411</u>	<u>(672,832,004)</u>	<u>2,576,083,770</u>
	Balance, June 30, 2002	Additions	Disposals	Balance, June 30, 2003
Nondepreciable assets:				
Land	\$ 12,171,606	1,654,065	—	13,825,671
Construction in progress	711,763,648	251,438,245	(75,625,039)	887,576,854
	<u>723,935,254</u>	<u>253,092,310</u>	<u>(75,625,039)</u>	<u>901,402,525</u>
Depreciable assets:				
Interceptors, regulators, and land improvements	492,215,378	212,294,699	(168,300,839)	536,209,238
Structures	697,685,428	252,909,033	(145,370,617)	805,223,844
Equipment	553,541,522	190,204,736	(170,732,760)	573,013,498
Accumulated depreciation	(547,161,543)	(44,013,270)	1,743,071	(589,431,742)
	<u>1,196,280,785</u>	<u>611,395,198</u>	<u>(482,661,145)</u>	<u>1,325,014,838</u>
Total	\$ <u>1,920,216,039</u>	<u>864,487,508</u>	<u>(558,286,184)</u>	<u>2,226,417,363</u>

(6) Indebtedness

The outstanding indebtedness of the Fund was \$2,375,152,599 and \$2,311,620,907 at June 30, 2004 and 2003, respectively. The interest rates on the outstanding bonds range from 4.2% to 6.5%. Net revenues of the Fund are pledged to repayment of bonds.

CITY OF DETROIT SEWAGE DISPOSAL FUND

Notes to Financial Statements

June 30, 2004 and 2003

Future debt service requirements at June 30, 2004 are as follows:

	<u>Principal</u>	<u>Interest</u>	<u>Total requirements</u>
Year ending June 30:			
2005	\$ 44,825,000	100,218,721	145,043,721
2006	46,945,000	98,019,977	144,964,977
2007	49,850,000	96,100,624	145,950,624
2008	50,364,128	94,767,689	145,131,817
2009	53,725,000	89,275,226	143,000,226
2010 – 2014	292,483,965	442,080,125	734,564,090
2015 – 2019	322,654,361	430,813,065	753,467,426
2020 – 2024	368,745,145	414,818,547	783,563,692
2025 – 2029	504,345,000	213,998,549	718,343,549
2030 – 2034	641,215,000	69,455,274	710,670,274
	<u>\$ 2,375,152,599</u>	<u>2,049,547,797</u>	<u>4,424,700,396</u>

In fiscal 2004, the Fund issued \$101,435,000 of City of Detroit, Michigan Sewage Disposal System Senior Lien Revenue Refunding Bonds, Series 2004-A. The net proceeds of the 2004-A Bonds will be used to refund certain of the City's outstanding Senior Lien Bonds and to pay cost of issuance associated with the 2004-A Bonds.

A portion of the Senior Lien Revenue Refunding Bonds, Series 2004-A was used to advance-refund \$38,135,000 of the outstanding Sewage Disposal System Revenue Bonds, Series 1995-A, and \$65,710,000 of Sewage Disposal System Revenue Bonds, Series 1997-A. The net proceeds of \$112,856,821 (after receiving a premium of \$12,830,333 and payment of \$1,408,512 in underwriting fees, insurance, and other issuance costs) were used to purchase U.S. Government securities. Those securities were deposited in an irrevocable trust with an escrow agent to provide for all future debt service payments on the 1995-A Series and 1997-A Series bonds. As a result, the 1995-A Series and 1997-A Series bonds are considered to be partially defeased, and a portion of the liability for those bonds has been removed from the balance sheet.

The advance refunding resulted in a difference between the reacquisition price and the net carrying amount of the old debt of \$4,938,589. This difference, reported in the financial statements as a deduction from bonds payable, is being charged to operations through the year 2024 using the straight-line method. The Fund completed the advance refunding to reduce its total debt service payments over the next 20 years and to obtain an economic gain (difference between the present values of the old and new debt service payments) of \$3,398,743.

In prior years, the Fund defeased certain bonds by placing the proceeds of new bonds in an irrevocable trust to provide for all future debt service payments on the old bonds. Accordingly, the trust account assets and the liability for the defeased bonds are not included in the Fund's financial statements. Similarly, the interest expense related to the defeased bonds and the related interest income earned on the escrow fund investments have not been recognized in the statements of revenues, expenses, and changes in fund net

CITY OF DETROIT SEWAGE DISPOSAL FUND

Notes to Financial Statements

June 30, 2004 and 2003

assets. As of June 30, 2004 and 2003, \$490,565,000 and \$487,245,000, respectively, of bonds outstanding are considered defeased.

Bonds outstanding at June 30, 2004 included \$1,556,769,307 of bonds callable at various dates after July 1, 2004. These bonds are callable at varying premiums, depending on the issue and length of time to maturity.

Subsequent to year-end, the Fund received loans from the Michigan Municipal Bond Authority Michigan State Revolving Loan Fund Program in the amount of \$28,458,285 for the construction of facilities.

(7) Long-term Liabilities

Long-term liability activity for the years ended June 30, 2004 and 2003 is as follows:

	Balance, June 30, 2003	Increase	Decrease	Balance, June 30, 2004	Amount due within one year
Bonds payable, net	\$ 2,298,123,743	206,122,328	(182,395,446)	2,321,850,625	44,825,000
Accrued workers' compensation	4,844,529	1,543,501	(1,181,346)	5,206,684	1,181,346
Accrued compensated absences	9,965,977	2,345,824	(153,538)	12,158,263	6,051,544
Total	<u>\$ 2,312,934,249</u>	<u>210,011,653</u>	<u>(183,730,330)</u>	<u>2,339,215,572</u>	<u>52,057,890</u>

	Balance, June 30, 2002	Increase	Decrease	Balance, June 30, 2003	Amount due within one year
Bonds payable, net	\$ 1,677,841,958	846,196,785	(225,915,000)	2,298,123,743	38,745,000
Accrued workers' compensation	6,970,321	—	(2,125,792)	4,844,529	1,160,901
Accrued compensated absences	9,659,491	536,944	(230,458)	9,965,977	5,573,893
Total	<u>\$ 1,694,471,770</u>	<u>846,733,729</u>	<u>(228,271,250)</u>	<u>2,312,934,249</u>	<u>45,479,794</u>

(8) Derivatives Not Reported at Fair Value

The Fund is a party to derivative financial instruments consisting of – interest rate swaps that are intended to effectively convert variable-rate debt to fixed-rate debt. These are not reported at fair value on the statement of net assets at June 30, 2004.

CITY OF DETROIT SEWAGE DISPOSAL FUND

Notes to Financial Statements

June 30, 2004 and 2003

Objective of the swaps: In order to better manage its interest rate exposure and to reduce the overall costs of its borrowing, the Fund has entered into seven separate fixed payer interest rate swaps.

Associated bond issue	Notional amounts (1)	Effective date	Fixed rate paid	Variable rate received	Fair values	Swap termination date	Final maturity of bonds	Counterparty credit rating
Sewage 1998-A	\$ 68,000,000	12/9/1994	4.512%	BMA (2)	\$ (5,985,380)	6/30/2019	6/30/2019	Aa2/AA-/NR
Sewage 1998-B	67,900,000	12/9/1994	4.512%	BMA	(5,970,646)	6/30/2019	6/30/2019	Aa2/AA-/NR
Sewage 2001 C-1	156,500,000	10/22/1997	4.428%	BMA	(15,608,636)	6/30/2023	6/30/2023	Aa2/AA+/AA-
Sewage 2001 C-2	124,500,000	10/22/1997	4.468%	BMA	(7,917,564)	6/30/2025	6/30/2025	Aa2/AA+/AA-
Sewage 2003-B	150,000,000	5/21/1999	4.137%	BMA	(6,647,282)	6/30/2029	6/30/2029	Aa2/AA+/AA-
Sewage Hedge Swap	137,500,000	4/1/2005	4.795%	BMA	(2,981,432)	6/30/2031	N/A	Aa2/AA+/AA-
Sewage Hedge Swap	125,000,000	8/31/2002	4.955%	BMA	(1,479,489)	6/30/2032	N/A	Aa2/AA+/AA-

1. Notional amount balance as of July 1, 2004

2. The Bond Market Association Municipal Swap Index

Terms, fair values, and credit risk: Certain key terms, fair market values, and counterparty credit ratings relating to the outstanding swaps as of June 30, 2004 are presented below. The notional amounts of the swaps, except for those with effective dates of April 1, 2005 and September 1, 2006, match the principal amounts of the outstanding debt. The swaps with effective dates of April 1, 2005 and September 1, 2006 were entered into to hedge future interest rate risk and will be associated with bonds expected to be issued prior to the effective dates. Except as discussed under rollover risk, the Fund's swap agreements contain scheduled reductions to outstanding notional amounts that match scheduled or anticipated amortization of associated bonds.

Fair value. Because interest rates have generally declined since the time the swaps were negotiated, most of the Fund's swaps have a negative fair value as of June 30, 2004. The negative fair values may be countered by lower total interest payments required under the variable-rate bonds, creating lower synthetic interest rates.

Credit risk. As of June 30, 2004, the Fund was not exposed to net credit risk because the swaps had net negative fair values. However, should interest rates change and fair values of the swaps become positive, the Fund would be exposed to credit risk in the amount of the derivatives' positive fair value.

The swap agreements contain varying collateral agreements with the counterparties. The swaps require full collateralization of the fair value of the swap should the counterparty's credit rating fall below certain rating levels by Fitch Ratings, Standard & Poor's, and/or Moody's Investors Service. Collateral on all swaps is to be in the form of U.S. Government securities held by a third-party custodian.

Basis risk. The Fund is not exposed to significant basis risk on its swaps because most of the variable payments received are based on the BMA index.

Termination risk. The Fund or counterparty may terminate any of the swaps if the other party fails to perform under the terms of the contract. In such cases, the Fund may owe or be due a termination payment depending on the value of the swap at that time. In addition, the Fund is exposed to termination risk, but not termination payments, on certain of the Fund's swaps related to Sewage Series 1998-A, Sewage Series 1998-B, Sewage Series 2001 C-1, Sewage Series 2001 C-2, and Sewage Series 2003-B. These swaps provide the counterparty with the option to terminate the swap agreement beginning on July 1, 2008, July 1, 2010, January 1, 2010, and July 1, 2013, respectively, upon the passing of certain

CITY OF DETROIT SEWAGE DISPOSAL FUND

Notes to Financial Statements

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BMA thresholds. If any of these swaps are terminated, the associated variable-rate bonds would no longer carry synthetic interest rates, but there would be no termination payment.

Rollover risk. The Fund is exposed to rollover risk on swaps that mature or may be terminated prior to the maturity of the associated debt. When these swaps terminate or, in the case of the termination option, if the counterparty exercises its option, the Fund will not realize the synthetic rate offered by the swaps on the underlying debt issues.

(9) Deferred Swap Termination Proceeds

During the year ended June 30, 2004, the Fund and its counterparty terminated a forward starting swap agreement related to the issuance of debt in fiscal year 2005. The Fund received a termination payment in the amount of \$14,056,137 that has been deferred to offset future debt service. The proceeds will be recognized over the life of the debt that will be issued in fiscal year 2005 using the straight-line method.

(10) Pension Costs and Obligation for Benefits

The City provides retirement benefits to its employees through the General Retirement System (the Retirement System). The Retirement System provides benefits through a defined contribution plan covering substantially all Fund employees and a defined benefit plan. Historical and trend information for the defined benefit retirement plan is located in the City's comprehensive annual financial report.

The City's funding policy provides for periodic employer contributions at actuarially determined rates that are designed to accumulate sufficient assets to pay benefits when due. The Sewage Disposal Fund incurred pension expenses of \$2,559,591 and \$1,569,978 in fiscal years 2004 and 2003, respectively.

Consulting actuaries determined the City's contribution to the Retirement System as a percentage of annual covered payroll for normal costs. The Retirement System's actuarially determined pension benefit obligation information is not separately available for the Fund.

Significant actuarial assumptions used for the years ended June 30, 2004 and 2003 are as follows:

Valuation date	June 30, 2003	June 30, 2002
Actuarial cost method	Entry Age	Entry Age
Amortization method	Level Percent	Level Percent
Remaining amortization period	15 years	19 years
Asset valuation method	3-year Smoothed Market	3-year Smoothed Market
Actuarial assumptions:		
Investment rate of return	7.9%	7.9%
Projected salary increases	4.0% – 9.50%	4.0% – 10.0%
Includes inflation at:	4.0%	4.0%
Cost-of-living adjustment	2.25%	2.25%

Additional information regarding citywide employee participation, benefit obligations, and funding status for the Retirement System is available in the City's comprehensive annual financial report.

CITY OF DETROIT SEWAGE DISPOSAL FUND

Notes to Financial Statements

June 30, 2004 and 2003

(11) Due (to) from Other Funds

During the course of operations, numerous transactions occur between individual funds and other City of Detroit funds for goods provided or services rendered. Related receivables and payables are classified as "due from other funds" or "due to other funds" on the balance sheet and are summarized as follows:

	<u>2004</u>	<u>2003</u>
Due from other funds (unrestricted):		
General	\$ 12,791	124,119
Water	40,401,103	60,562,278
Total due from other funds	<u>\$ 40,413,894</u>	<u>60,686,397</u>
Due from other funds (restricted):		
General	\$ 15,584,333	—
Water	5,104,477	2,380,429
Total due from other funds	<u>\$ 20,688,810</u>	<u>2,380,429</u>
Due to other funds (unrestricted):		
General	\$ 7,508,820	10,033,063
Water	27,166,286	28,496,907
Total due to other funds	<u>\$ 34,675,106</u>	<u>38,529,970</u>
Due to other funds (restricted):		
General	\$ 48,509	48,509
Water	5,158,637	6,735,246
Total due to other funds	<u>\$ 5,207,146</u>	<u>6,783,755</u>

(12) Capital Improvement Programs

The Fund is engaged in a variety of projects that are a part of its five-year Capital Improvement Program (the Program). The total cost of this Program is anticipated to be approximately \$2.1 billion through fiscal year 2007. The Program is being financed primarily from revenues of the Fund and proceeds from the issuance of revenue bonds.

The total amount of construction contract commitments outstanding at June 30, 2004 and 2003 was approximately \$647 million and \$924 million, respectively.

(13) Rate Adjustments

The U.S. Environmental Protection Agency (EPA), in attempting to ensure that user charges are proportional in effect as well as in their design, requires grantees to compare budgeted wastewater contributions, revenues from users, and user classes to actual results and make appropriate rate adjustments in the second succeeding year. The accompanying financial statements reflect management's estimates of the current and noncurrent amounts receivable from and refundable to customers, in accordance with the regulations. Although subsequent adjustments to these amounts may occur, management does not believe the impact would be material to the Fund's financial position or results of operations.

CITY OF DETROIT SEWAGE DISPOSAL FUND

Notes to Financial Statements

June 30, 2004 and 2003

(14) Contingencies

The operation of the Fund's Waste Water Treatment Plant (WWTP) is subject to extensive regulation pursuant to the Federal Water Pollution Control Act, as amended by the Clean Water Act of 1977 and the Water Quality Act of 1987 (collectively, the Clean Water Act). Included in the regulatory framework established by the Clean Water Act is the National Pollutant Discharge Elimination System (NPDES) permit program, which requires operation of wastewater treatment facilities according to discharge limitations and other requirements as set forth in permits issued to each facility. The U.S. EPA has authorized the State of Michigan Department of Environmental Quality (MDEQ) to implement and enforce the federal NPDES permit program.

The Fund operates the WWTP pursuant to an NPDES permit that took effect on January 1, 2004 and which is due to expire on October 1, 2007.

The Fund is also a defendant in numerous other alleged claims and lawsuits. The Fund and the City's Legal Department have estimated a reserve for the potential outcome of such claims or the amount of potential damages in the event of an unfavorable outcome for each of the above contingencies, which is included in the accompanying financial statements. The Fund's management and the City's Legal Department believes that any differences in reserved amounts, and other potential claims against the Fund not covered by the Fund's insurance, resulting from such litigation will not materially impact the Fund's financial position or results of operations.